The State-Market Problematique and Industrialisation in Asia: Introductory Remarks

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1. Themes and Perspectives

Since 1960, eight high-performing Asian economies have grown more than twice as fast as the rest of East Asia, roughly three times as fast as Latin America and South Asia, and five times faster than Sub-Saharan Africa (World Bank, 1993). The eight countries are the following: Japan, South Korea, Taiwan, Thailand, Malaysia, Hong Kong, Singapore and Indonesia.

Neo-classical economists have explained this sustained growth trend mainly by referring to the concerned countries' reliance on international trade and the absence of price controls and other distortionary policies. They have emphasised that the successful Asian economies have been better than others at providing a stable macro-economic environment, establishing reliable legal frameworks and promoting human capital formation (Wolf, 1998).

So-called revisionist economists, on the other hand, have argued that the high-performing Asian economies have achieved their high growth rates because the political authorities have 'governed the markets' in critical ways (Amsden, 1989; Wade 1990). Rather than leaving price formation to the market, these authorities have deliberately distorted relative prices in order to alter the incentive structure with a further view to boost strategically important industries.

Recently, a World Bank commissioned study tried to strike a balance between these two major approaches to understanding

the 'Asian miracle' (World Bank, 1993). The study team labelled their approach 'a functional approach to growth'.

The papers in the present volume will briefly review the above approaches, their basic arguments and their contributions to theory formation. But the major idea is to add to these approaches:

1) an institutional perspective which tries to reveal the diverse institutional arrangements affecting industrial activity and governing policy formation and implementation; and

2) a comparative perspective which tries to identify the most important differences in the institutional frameworks for industrialisation in the high-performing Asian economies as compared with those prevailing in other Asian countries, particularly India, and selected African countries.

By comparing approaches, essentially developed within economics, with theoretical frameworks and methodologies which have emerged within political science and sociology it is believed that we might learn more about the strengths and weaknesses of the various approaches in the context of development studies.

A central issue in the international debate on the reasons for success in East Asia - and the reasons for failure in South Asia and Africa - is the question of the most appropriate role for the state and the market. This issue is at the centre of attention in this introductory paper.

2. The Debate on State versus Market as Principal Institutional Framework

The question regarding the respective roles of the state and the market in the development process has been debated continuously since the end of the 1940s. There are great variations in how different countries, during different periods of time, have arranged the interactions between state and market. These variations - surprisingly - have not played any central role in the more recent debate, where the views have often been presented as being in favour of *either* an interventionist state and a mixed economy *or* a non-interventionist state and a free-market econ-

omy. It has been largely a debate about a state-managed versus a market-led development strategy.

As a starting point, it is deemed appropriate to describe briefly the state-managed development model, because this is the one which preoccupied most of the research within development studies from the 1950s till the end of the 1970s. This was also the model which had the greatest impact upon the development strategies pursued by a majority of Third World countries during the same period.

We shall try to summarise the rationale behind this model in the way it has been formulated especially in development economics. Afterwards, we shall look at a number of the problems and weaknesses of this model which have been emphasised continuously in the theoretical debates. A special section examines the resurrection of neo-classical economics in development research and their far-reaching propositions in favour of a market-led development model.

After having contrasted the two models in their pure forms, we shall introduce more nuanced approaches which look at the social embeddedness of markets and search for more complex interrelations between market and state. The introduction ends with a section on the political economy of the reform process with particular emphasis on the political feasibility for carrying through the changes in economic policy which neo-classical and other theories have proposed since the end of the 1980s. In this connection, it is necessary to consider the significant differences among the countries of the Third World.[1]

It should be borne in mind that the distribution of roles and functions between state and market is only one aspect of a more comprehensive problematique where questions concerning political decentralisation, popular participation and people-managed development also come in. These themes are not addressed in the present paper.

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[1] A more comprehensive review of the theoretical literature on state and market in societal development will appear later in John Degnbol Martinussen, *Society, State and Market*, London, Zed Press (forthcoming, Autumn 1996)

3. The Rationale behind State-managed Development

In a simplified outline of the concept the state-managed development model can be characterised by two central elements: One is a state-building strategy that aims at anchoring the state in the surrounding society. It is a strategy that tries to extend the state institutions, so that they reach down and out to the citizens. The other element is a state-managed development effort which involves the use of the state bureaucracy as an engine of growth and development, and as a central planning and allocation mechanism.

The rationale behind this model has been formulated in many different ways. Basically, the arguments in favour of extensive state interventions have centred around the fundamental economic structures of backward societies, their undeveloped markets and the absence of a sufficiently strong entrepreneurial class. The principal argument has stated that, under the existing conditions, Third World countries would not be capable of initiating a sustainable and self-reinforcing growth process, unless the state intervened and coordinated the development efforts.

At the same time, there was an implied assumption behind the whole argument that the state could and would act as a rational actor to the benefit of the society as a whole, i.e. in the interest of the common good. Pushed to extremes, it could be formulated as three simple propositions: (a) the economists should advise; (b) the politicians should decide; and (c) the government officials should implement the correct economic policies.

Instead of repeating the more specific arguments embodied in the various theories in favour of state interventions, we shall briefly look at the main arguments in support of different types of state interventions. At least five types of state interventions may be identified:

a) Procurement of general legal and institutional preconditions for production and exchange of commodities and services, including a legal framework for enforcing property rights, contracts, etc.;

b) Macro-economic policies such as fiscal, income and exchange rate policies;

c) Procurement of material infra-structure, including roads and railways, and provision of public services in areas like education and health;

d) Operational controls over private-sector companies; and

e) The state's direct participation in the production of goods and services.

In the theoretical debate, there has been disagreement on the state's role in all these five areas, though it is the market-replacing types of interventions - (c), (d) and (e) - that have given rise to most of the serious controversies. Disagreement concerning the first two types of interventions has been limited to nuances in the perception of how much the state should intervene.

The principal reason why the state should participate actively in the *procurement of material and social infra-structure* has focused on the notion that these necessary preconditions for economic growth and social progress would not be produced by the private sector.

Similarly, the *direct participation of the state* in certain production sectors has been based on the argument that private capital would not be forthcoming in a number of strategic areas. The more specific reasons could vary. One could be that the rate of profit which could be realised would be considerably below the prevailing average. A second reason could be that the amount of capital required would be too large for any single private enterprise, or at least for any domestic firm. A third reason could be that the gestation period would be too long as compared with alternative investments. Finally, the risks involved could be prohibitive for private entrepreneurs.

As regards the *operational controls over private-sector companies*, these interventions have been justified by, *inter alia*, the need to create a better balance between economic sectors; dispersal of growth and income opportunities geographically and in social terms; or the wish to counteract foreign control or economic power concentration.

However, it is not these attempts at justifying extensive state interventions that are in focus here, and for this reason they shall not be expanded on further. Instead, attention shall be drawn to the criticism of the state-managed model. This criticism has been pursued partly with reference to empirical evidence, partly with

reference to general economic, especially neo-classical theory. Both types of criticism shall be briefly reviewed.

4. Neo-Classical Criticism of the State

The World Bank has played a central role in the experience-based criticism by continuously emphasising the negative economic effects of extensive state interventions (e.g. in the annual *World Development Reports*). However, there is also a copious amount of empirical literature from other sources concerning the pros and cons of state interventions in a large number of individual countries (e.g. Little, Scitovsky & Scott, 1970).

Regarding the involvement of the state in the *procurement of material infra-structure*, the World Bank and others have emphasised that parastatals and public enterprises generally have a poor performance record. They have functioned ineffectively and inefficiently. Most of the states in the developing countries have not had either the necessary financial resources or sufficient administrative and technical capacity to handle the tasks. This has created problems for the private sector, which in turn has had to establish parallel structures and supplies itself.

Operational controls over private-sector enterprises have been criticised for being expensive solutions to short-term problems. Government controls which have interfered directly with the economic functioning of private enterprises, including their investment priorities, have often proved costly, ineffective and even counter-productive in the sense that they have brought about the opposite effect to that intended.

Finally, with regard to the state's *direct participation in the productive sector*, the criticism has especially emphasised the low capacity utilisation and the over-employment in public industrial undertakings. As a result, cost-effectiveness has been low, often to the extent that the public sector undertakings have made losses even in areas where private companies have been able to earn substantial profits. For governments with an increasing deficit on their public accounts this has been experienced as unacceptable.

From the point of view of neo-classical economic theory, general observations such as these have been interpreted as empirical confirmations of how unfavourable the effects are, when the state interferes with the private sector and the play of the free-market forces. This interpretation is not new, but it was advanced with still greater vigour towards the end of the 1970s.

Around 1980, it became generally accepted among the decision-makers in the OECD-countries, and in the World Bank and the International Monetary Fond (Toye, 1987).

The principal thesis advanced by the neo-classical economists was that free competition and market mechanisms, essentially in all countries and under all circumstances, would bring about a more optimal allocation of production factors and a more optimal distribution of commodities than a regulated economy with administrative controls and central planning.[2] They recognised that there were market failures and that these were more extensive in most of the developing countries than in the OECD-countries. However, they rejected the idea that special theories or strategies were required for the developing countries. In addition, they claimed that the market failures were insignificant as compared with the consequences of government failures, which they saw as being the most serious problem for economic progress in the backward countries.

Summing up the various neo-classical contributions, at least four major causes of government failures may be identified:

a) self-seeking and calculating politicians and other actors, who form coalitions to control the allocation of resources in accordance with their own narrow interests;

b) corrupt behaviour among politicians and government officials;

c) lack of, or absence of, competent administrators with the necessary understanding of economics and business operations; and

d) general lack of knowledge about the private sector and its way of functioning.

The neo-classical economists often applied, in their extensive analyses, an ideal-type construction of a perfect market with unrestricted competition, and evaluated the developing countries in relation to this by indicating the respects in which, and the extent to which, these countries differed from the ideal-type model. This method resulted in quite interesting and thought-provoking empirical studies which commanded, and rightly so,

[2] The more specific formulations of this principal thesis vary, but basically the position can de identified in writings by economists such as Deepak Lal, Bela Balassa, J.N. Bhagwati, and Ian Little.

respect among many development researchers throughout the 1980s.

On the other hand, the neo-classical economists' strategic recommendations caused immediate and intense criticism from both economists and other development researchers. As has already been implied, they proposed that the economic role of the state should be minimised. The state should be 'rolled back'. Instead, it should be left to the price mechanisms in competitive markets to decide what should be produced and in what quantities. The overriding consideration was to get the prices right, because the market would then take care of the dynamics, the growth and the structural transformation of the backward economies.

In comparison with the Keynesian inspired development economics of the previous decades, the neo-classical economists shifted the whole focus from 'getting the policies right' to 'getting the prices right'. More specifically, the neo-classical strategy in the 1980s involved the following elements:

a) All distorting interventions in the pricing mechanisms should be abolished in order to achieve maximisation of growth and development;

b) foreign trade should be liberalised to remove the incentives for inward-looking economic behaviour and be replaced by incentives for outward-looking and export-oriented economic activity; and

c) the public sector should be reduced in size through privatisation of public undertakings and relinquishment of as many economic tasks as at all possible to private companies.

During the 1980s, the neo-classical economists had considerable influence on the international development debate, and their recommendations were generally accepted by the International Monetary Fund and the World Bank, in addition to many bilateral donor organisations.

Towards the end of the decade, the neo-classical positions, however, were gradually forced onto the retreat, both in the theoretical debates and in the management of international development co-operation. They came increasingly to be perceived as a reaction that had gone too far the criticism of the previously so dominant state-managed development model (Killick, 1989).

Instead, a more balanced approach emerged between the state-managed and the market-led model - a compromise which came to set the agenda for the international debate and development efforts of the 1990s.

5. Market and State: A Question of Division of Labour

Current thinking about the state has exposed the neo-classical dichotomy - state *or* market, public *or* private - as false in two respects. First, there is no clear borderline. Between the 'pure' cases of public and private enterprises there are in most countries several types of overlapping ventures like jointly-owned companies; public companies with hired-in private sector management; private firms operating publicly-licensed franchises; co-operatives; etc. Second, markets require a legal and regulatory framework which only governments can provide. Legal entitlements and liabilities are just as important as the market system of commodity exchange. To this could be added that neither the state nor the market in the developing countries function in agreement with the assumptions and the hypotheses of the theories (Stiglitz, in: Meier, 1989, p. 101ff.).

Against this background, the central issue becomes more complex than just choosing between state or market. Positively formulated, the overriding concern is to determine the most appropriate division of labour between the two with a further view to avoiding or compensating for both state failures and market failures.

When considering the desirable role of the state, there are essentially two different issues involved, according to the British economist, Tony Killick (Killick, 1989):

a) How large should the state be in relation to total economic activity?

b) What types of policy instruments should the state employ?

We may add to these two questions a series of issues related to the institutional arrangements:

c) What kind of institutional framework is the most appropriate? Or more specifically, what kind of framework for policy

implementation (state institutions), and what kind of framework for industrial activity (non-state institutions)?

There is hardly any doubt that the vast majority of developing countries could improve their economic performance by introducing so-called market-oriented or market-friendly reforms. But this need not result in a reduction of the size of the state. In general, market-oriented reforms are likely in practice to alter rather than reduce the demands on public policy and public institutions. The point is that the absolute size of the public sector and the quantity of state interventions are less important than the way in which the state acts and the kind of relationships it establishes with the private sector.

Based on this understanding it becomes important to examine government interventions with a view to determining which should be continued unchanged, commercialised, privatised, delegated to local authorities, or discontinued altogether.

In the assessment of state interventions from this point of view a distinction can be made between purely economic considerations, on the one hand, and considerations regarding the politically possible, on the other. The question is, in other words, what is economically feasible and what is politically feasible. The question is further, what is economically and politically feasible *at a given time*. Recent analyses have strongly pointed to the need for continuous adaptation to changing circumstances, particularly to extract maximum benefits from the world market.

From the point of view of economic feasibility, the key task is to establish a working relationship between the state and the private sector. Following contemporary conventional thinking on this issue, as proposed also by World Bank economists, states should do less in those areas, where markets work properly. They should do more, where markets cannot be relied upon. To the extent that policy interventions are necessary, they should work with or through the market forces rather than against them.

From the point of view of political feasibility, the task is to find out whether sufficient support can be mobilised for the proposed policy reforms.

6. Market and State: The Far Eastern Experiences

The Far Eastern experiences and the interpretations of these have played such an important role for general theory construction concerning the role of the state that there is reason to look a little closer at the different views. At least three can be identified: (a) The pure neo-classical view; (b) the revisionist view; and (c) the so-called functional approach.

Adherents to the neo-classical view stress the high-performing Asian countries' success in getting 'the basics right'. They assert that the states have refrained from interfering with price formation, foreign trade and the economic functioning of private enterprises. At the same time, they note that the governments in these countries have been active when it comes to providing a stable macro-economic environment, a reliable legal framework, and political incentives for export-oriented industrial development. In addition, the governments have actively invested in education and health (see e.g. Chen, 1979; Wolf, 1988).

This interpretation has been strongly criticised by 'revisionists' like Alice Amsden and Robert Wade. They argue that the states in South Korea and Taiwan, in particular, have intervened to a such extent that they have 'governed the markets' in critical ways and consciously manipulated prices to promote selective sector development. The 'revisionists' contend that the East Asian governments have consistently and deliberately remedied market failures and altered the incentive structure to boost industries that would not otherwise have thrived (Amsden, 1989; Wade, 1990). Especially, the capital markets have not conformed to the neo-classical model. They have been controlled by the governments by means of both interest rate policies and direct control measures. So-called 'contests' have been organised by the governments in order to avoid 'unnecessary' competition among national companies. Finally, there has in reality existed for a long period tight import controls and several restrictions on foreign investors.

The overall picture emerging from the case of South Korea - and also from the case of Taiwan with only a slightly different composition of the policy instruments - is one of a high degree of state interventionism. But - and this is an important point - the interventionism noticed in the two East Asian and other high-performing economies has been different from state interventionism in South Asia and Africa. In the former cases, the emphasis

has been on providing a policy-framework for competition, growth and export, while in the latter cases it has been on restrictions and control. Also, when the Far Eastern authorities have forced the companies into some form of coordination, it has happened through economic 'contests' among firms with a view to combining the benefits from co-operation and competition.

The third view, the functional approach to explaining the high growth rates in some Asian economies, has been formulated by a group of researchers and employees of the World Bank (World Bank, 1993). Based on an extensive investigation of the Far Eastern high-growth countries they have reached conclusions which combine some of the views expressed by the revisionists with some of those propagated earlier by the neo-classical economists.

Like the revisionists, they recognise that contests with the state as 'referee' in important respects has worked just as well, or even better, than free-market competition, but they emphasise that the preconditions for this are hardly ever found in other developing countries. This applies, in particular, to the competence and independence of the civil service. In addition, they note that the Far Eastern governments' mode of intervening has, as a whole, been primarily market friendly. Only in exceptional cases have the governments tried to bypass or substitute the market mechanisms.

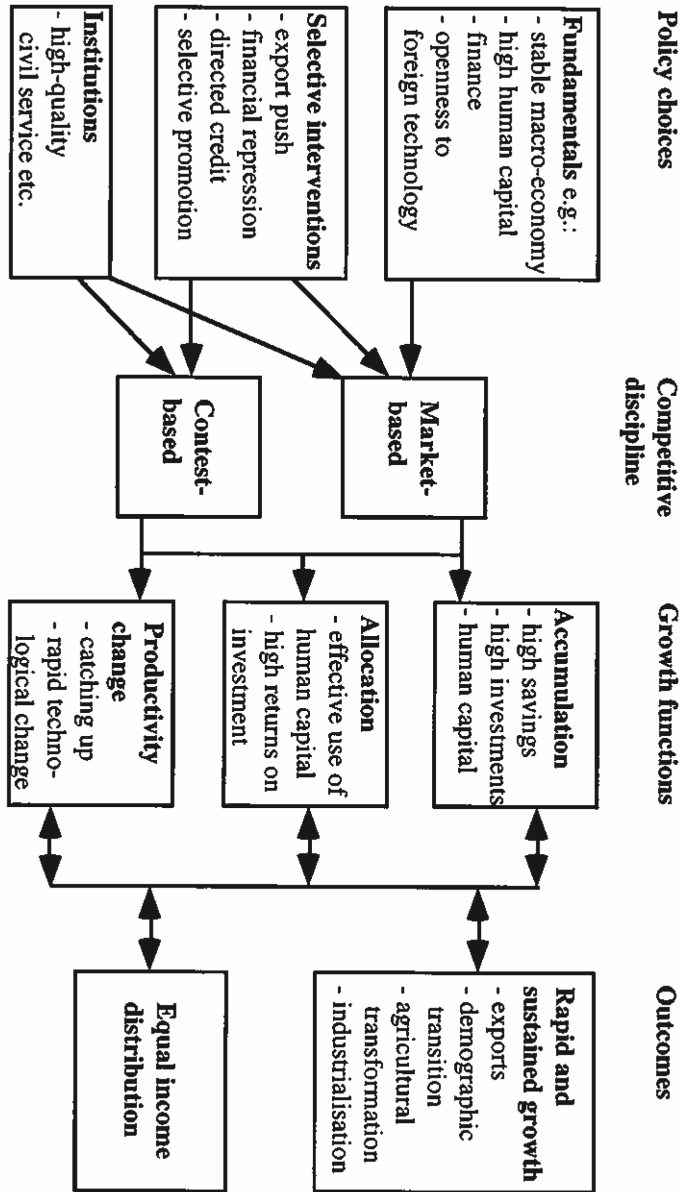
The whole approach is far less dogmatic than that which characterised World Bank studies in the 1980s. The functional theory outlined in the summary report, *The East Asian Miracle*, is of such quality that it deserves to be considered carefully in the 1990s' discussions on the state-market relationships. It is therefore briefly reviewed in the following paragraphs.

The figure below in a simplified form portrays the functional approach to understanding growth in the high-performing Asian economies. The figure shows the interaction among (a) two sets of policy choices; (b) two methods of competitive discipline; (c) three central functions of economic management; and (d) the outcomes in terms of growth and income distribution.

The solid lines with arrows indicate how policy choices contributed to outcomes via attainment of the three growth functions. Many policies contributed simultaneously to two or even three functions. High investments in human capital, for instance, contributed both to accumulation and to productivity-based increase of competitiveness. Openness to foreign technol-

ogy was another major vehicle for productivity-based catching up.

A Functional Approach to Growth:



Source: World Bank, 1993, p 88. Simplified here.

The double-arrows indicate numerous self-reinforcing feedbacks. For example, rapid growth and relatively equal income distributions contributed to accumulation by increasing savings rates and generating larger and more effective investments in human capital.

The policies listed as fundamentals affected the attainment of growth functions primarily through market-based mechanisms of competitive discipline. The selective interventions went beyond that by altering the market incentives by providing, for instance, special incentives for manufactured exports or performance-based subsidised credit.

Some of the selective interventions in reality guided and in some cases even bypassed markets, but according to the functional theory that made sense within a neo-classical framework, because they addressed particular market failures and were limited so as not to interfere too much with the competitive environment and the functioning of private enterprises. The World Bank report describes the mix of policies pursued as well-adapted to changing circumstances and priorities, in contrast to policies pursued by most other developing countries which have been characterised either as lacking purposeful direction or as rigid continuations of demonstrably unsuccessful measures.

The more balanced interpretation offered by the World Bank, as compared with the original neo-classical positions, should also be considered in relation to the sophisticated analyses contributed to the present volume by Linda Weiss, Laurids Lauridsen and others (cf. further Weiss, 1995).

7. The Political Feasibility of Economic Reforms

The question of political feasibility has already been introduced above. It is now appropriate to deal more explicitly with this aspect, which has been giving considerably more attention among mainstream development economists and decision makers within international development agencies since the late 1980s.

As noted earlier, the basic conceptions which used to influence mainstream economics for many years viewed the state is a rational actor, guided by the common interests of all its citizens. The state could act irrationally when the amalgamated preferences of the citizens were not known but, in principle, the pro-

blem then was merely to work out the 'best' policies and the 'best' role for the state.

This is not the conception embodied in the current rethinking of the state among development economists and staff of international agencies like the World Bank and the UNDP. It is interesting to note that both these major agencies have recently addressed the whole issue of political feasibility and the nature of the state in explicit terms (World Bank, 1991, Ch. 6; UNDP, 1991) According to their (new) conception, which is more in keeping with political science concepts, the state is both an actor and an institutional framework for resolving conflicts of interest. As an actor, the state acts in accordance with the most powerful groups, possibly reflecting a compromise between their vital interests and those of other groups of society.

It follows from this basic conception that the crucial question is not merely to work out the 'best' policies but rather to work out the 'best possible' policies within the framework of the existing power structure. The 'best' policies in the traditional, purely economic sense may be opposed to powerful interests and therefore not adopted - and if adopted because of external pressure - prevented from bringing about the intended effects.

This has been part of conventional wisdom for many years among political scientists. However, the interesting point here is that this line of reasoning is currently being integrated into the discussion of the feasibility of economic reform.

Of particular relevance to the discussion of a framework for promoting private enterprise is an observation made by the World Bank according to which those who stand to loose from privatisation and deregulation are generally better organised and politically more powerful than those who stand to gain (World Bank, 1991, p 104). Those who stand to loose are vested interests within government, or more specifically politicians who augment their political support by means of distributing public resources and privileges; officials earning a decent living from applying discretionary controls; and managers and workers with secured employment in over-staffed public enterprises.

The major point which emerges from this line of reasoning is that historically as well as under contemporary conditions there may be good - political - reasons for choosing and continuing the policies of government control and command, as seen from the perspective of the ruling groups in many developing countries. Consequently, the more market-oriented policies, even when justified on economic grounds, may not be politically feasible.

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Noting that the most desirable market-oriented reforms, as seen from an economic perspective, in many cases cannot be implemented because of the prevailing political power structure has important implications for the theoretical approach to the issue. In this lies a clear incentive to always combine the economic analysis with an investigation of the political setting - an incentive to work with the political economy of economic reforms. This is how, in another paper contributed to this volume, I propose to deal with the policies and institutional frameworks for industrial development in India.

References

(See the list of references attached to the other paper contributed to this volume by John Degnbol Martinussen)